Internal Revenue Service
memorandum

CC:TL:Br3
PSHorn

date: NOV 4 1987

to: District Counsel Manhattan CC:MAN

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

Your ref: CC:MAN:TL: SKatz-Pearlman

This is in response to your additional technical advice request dated October 19, 1987, wherein you sought our views on recent developments herein. These cases have previously been the subject of our technical advice response dated August 24, 1987.

ISSUES

1. Whether the respondent can argue that the salary from the [redacted] is income to [redacted] ("[redacted]") where such amount was accepted as income to his personal service corporation ("PSC"), [redacted] as stated on its corporate return as filed.

2. Whether the deficiency cases against [redacted] and other similarly situated [redacted] should be litigated if the corresponding retirement plans of their respective PSCs do not have their qualified status revoked for the years at issue.

3. Whether the PSC's earning of outside income beyond the [redacted] salary, enabling the retirement plan to possibly remain qualified, does not affect our ability to attribute the salary to the [redacted].

CONCLUSIONS

1. The respondent should acknowledge that it has taken an inconsistent, albeit protective, position in the two cases but that it does not intend to tax this income twice.

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2. While the deficiency cases could proceed without revocation of the retirement plans, the qualified status of the retirement plans should be revoked. The respondent's litigating position in the deficiency cases appears more coherent and reasonable if consistent with its administrative disposition of the associated retirement plans.

3. The PSC's earning of outside income may enable the retirement plan to retain its qualified status but does not affect the associated deficiency case attributing the salary income to the [redacted].

DISCUSSION

The preliminary facts have been set forth in our previous correspondence and will not be repeated here. Certain additional information, however, has come to light since our response and a conference call on October 23 was held between Jay Hamelburg, Bernie Goldstein, and Sharon Katz-Pearlman of your office with Pat Dowling, Sommers Brown, Paul Horn, and Gus Fields. You indicate at least two problems which may affect your ability to proceed. The first problem is that the statutory notice to [redacted] did not remove the income which was attributed to [redacted] nor disallow its salary or pension deductions. The only adjustment to [redacted] was to disallow certain unsubstantiated business deductions. The second problem is that the retirement plan of [redacted] has not had its qualifed status revoked.

Issue 1

We do not believe that the income issue should affect our ability to proceed. Clearly, to be consistent with our primary argument that all the salary income is attributable to [redacted], [redacted] should have no income and also no pension deduction. Since our position is that [redacted] had no income, the salary and pension deductions should be denied pursuant to secs. 404 and 162. Finally, any miscellaneous business expenses would probably also be inappropriate under sec. 162.

While taking this action against [redacted] would have been consistent with our position vis-a-vis [redacted], it could potentially have left us whipsawed if the case against [redacted] was lost. In this particular instance the net tax result to [redacted] is almost the same whether or not we win in [redacted]; the whipsaw concern is thus not as great. This wash can be demonstrated by assuming the following figures for [redacted] as controlled by the two possible outcomes in [redacted]:

[redacted] loss		[redacted] win	
Income	100	Income	0
Salary deduction	75	Salary deduction	0
Plan deduction	20	Plan deduction	0
Misc. business exp.	5	Misc. business exp.	0
Taxable income	0	Taxable income	0

Some de minimis tax was paid by [redacted] so if we are successful in [redacted] there may be an overpayment due to it. If, however, the business expenses are not substantiated and we lose [redacted], then there may be taxable income to [redacted]

It does not disturb our litigating position in [redacted] to maintain this inconsistent yet protective position in [redacted] Indeed, if unsuccessful in [redacted] we would accept the [redacted] return as filed. If successful in [redacted] the necessary adjustments to [redacted] can then be made. For the present, no disallowance of [redacted]'s pension contribution is required and would be explained by the necessity of taking a protective position in the event [redacted] is lost. We therefore agree with you that it is not now necessary to do anything in [redacted] as it is controlled entirely by the outcome in [redacted].

A further question arises regarding whether [redacted] may claim the business expenses of [redacted] if we are successful in attributing all the income to him. Such costs incurred by [redacted] should be deductible by [redacted] if they would have been deductible if directly paid by him. <u>See</u> <u>R.O.H. Hill, Inc. v. Commissioner</u>, 9 T.C. 153 (1947) (where partnership was disregarded and income attributed to petitioner, certain corresponding expenses paid by partnership also allowed to petitioner); <u>Heymann Mercantile Co., Inc. v. Commissioner</u>, 7 TCM 856, 869 (1948) (payments by entity other than petitioner allowed as deduction to petitioner). While petitioner is not self-employed, certain expenses paid by [redacted] may nonetheless be deductible by [redacted] as professional costs of being employed as a [redacted]. See sec. 1.162-6; Stemkowski v. Commissioner, 76 T.C. 252 (1981), rev'd and remanded 690 F.2d 40 (2nd Cir. 1982), modified on remand 82 T.C. 854 (1984). Other costs paid by the PSC may not be related to the conduct of the trade or business of being a [redacted] and may not be deductible by [redacted], see sec. 1.162-2, et seq.

Issue 2

The failure to simultaneously revoke the qualified status of [redacted]'s retirement plan should not determine the outcome of the deficiency case against [redacted] but it could nonetheless inpinge upon our ability to successfully litigate this case. As you are aware, we were faced with a factual situation similar to this in Professional & Executive Leasing, Inc. v. Commissioner, 89 T.C. No. 19 (Aug. 13, 1987). Therein we argued that the retirement plans established by the leasing entity for the various professionals were not qualified because they violated the exclusive benefit rule of sec. 401(a)(2). The exclusive benefit rule forbids the plan from covering a nonemployee.

Our argument here draws on Professional & Executive Leasing ("PEL") but is slightly different. We will not argue that [redacted] is not an employee of [redacted] but rather use the principle of PEL to show that the services performed by [redacted] indicate that all compensation was earned as an employee of the [redacted]. In PEL we did not argue that the professionals were not employees of their own PSCs or operating businesses, rather we only argued that they were not employees of the leasing entity. Similarly we need not argue that [redacted] is not an employee of his PSC, only that [redacted] earned no compensation from this relationship. Since [redacted] earned no income as an employee of the PSC, the retirement plan is not qualified under sec. 401(a)(16) for failing to satisfy the applicable sec. 415 limits on contributions. (See discussion Issue 3).

It may strain our argument to the court to explain that all the income is taxable to [redacted] when we have not disqualified the retirement plan. This difficulty would be aggravated if we could not argue that the retirement plan contributions (which we are including in income as salary) resided in a nonqualified trust. At this time we have contacted the Chicago Key District in an effort to find out what has happened to the retirement plan cases for the various [redacted]. Please let us know if any additional cases come to your attention so we can focus the Key District's search. As you mentioned, it will probably be necessary to postpone the scheduled trial date in this case. You have indicated that Judge [redacted] would probably not be adverse to such a delay as he is interested in combining all the [redacted] cases. If we eventually discover that the retirement plan revocation cases cannot be resurrected, we would be prepared at that time to discuss whether any suitable litigation vehicle remains to test the issue herein. Also, we have advised Examination Programs of this case and they are surveying their offices for similar issues involving professional athletes in order to determine whether a litigation project should be initiated.

Another question involves the taxation of interest earned by the retirement plan's trust. If the plan and trust remain qualified the earnings are not taxed, sec. 501(a). If, however, the qualified status is removed the trust would have to pay a tax on the earnings thereon to the extent the statute of limitations remains open. A Schedule P needs to have been filed with the plan's annual report Form 5500 to start the running of the statute. If the statute is closed, the tax on the earnings cannot be collected from [redacted] prior to his actual withdrawal of such amounts unless the trust can be considered to be a grantor trust created by [redacted], secs. 671 et seq. If not a grantor trust, we would argue that when [redacted] were to withdraw these amounts he would have no basis in this amount under sec. 72(e) and would be taxable in the year of withdrawal. Finally, if it were necessary to proceed without disqualifying the trust, any income successfully attributed to [redacted] should give him a corresponding basis in his interest in the trust for purposes of any subsequent withdrawal.

Issue 3

A final question concerns whether the retirement plan can remain qualified where the PSC earns outside income via endorsements, advertising, etc. The [redacted] case is simple because the PSC has no outside income through any other activity; it therefore cannot make any plan contributions for [redacted]. Where, however, the [redacted] earns outside income it could be in his capacity as an employee of the PSC. We would have to investigate whether under sec. 401(a)(16) the plan may fail to meet the sec. 415 limits on contributions and therefore is disqualified. This would be the case where the contributions exceeded the applicable percentage compensation limits as to the amount received by the individual as an employee of the PSC. In this instance the money purchase pension plan, a defined contribution plan, would be subject to sec. 415(c)(1). In the case of a defined benefit plan sec. 415(b)(1)(A) would provide the applicable limit. If on the other hand the outside income was sufficient to cover the sec. 415(c)(1) limits then the plan could not be disqualified on this ground. The continuing qualification of the plan would not, however, affect our ability to attribute to the player the salary earned as a common law employee of the [redacted]

In summary, we believe this case can proceed as initially set up once the status of the retirement plan revocation cases have been established. We would also like to point out that while this case involves athletes where the use of PSCs is quite common, we believe any judicial bias against upsetting the use of such long standing arrangements can be overcome. The thrust of our argument is not against PSCs nor their frequent use by athletes. Rather our concern is that salary paid to individuals as employees should not be diverted from the income of the true employee into his PSC. This result is important not only in the income tax area but also to ensure the proper collection of the employment tax. The attribution should be the same regardless of whether the diversion is attempted by [redacted], clerical secretaries, managers, or any other common law employee.

Sincerely,

WILLIAM F. NELSON
Chief Counsel

By:
SOMMERS T. BROWN
Senior Technician Reviewer
Branch No. 3
Tax Litigation Division